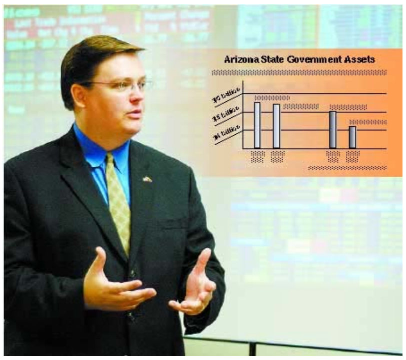
ARIZONA CAPITOL TIMES

As reprinted from 11/21/2008

Arizona Selling Out: Revenue deficit eating away at state investment pool



Wild swings in the stock market that have decimated millions of Americans' portfolios have left the state's investments relatively untouched. Unfortunately, when it comes to Arizona's multibillion-dollar investment pool, the good news ends there.

While the recent market turmoil may not have done much to devalue the state's investments, the economic downturn has exacerbated the budget crunch and leaves the state few options other than to cash in so it can keep paying its bills.

State revenue for the fiscal year is expected to fall short of original projections by as much as $1.4 billion. And as the state prepares to spend what remains of its cash reserves to bridge the budget gap, the investment pool is evaporating quickly.

The problem is familiar to cash-strapped Arizona families: The state is simply spending more money than it is taking in. The state has a $9.9 billion budget for the fiscal year 2009, but is now expected to bring in just $8.5 billion to $8.7 billion in revenue.

Thanks to the $11.8 billion investment pool it shares with a collection of local governments and the state land trust, there is enough money in reserve to cover the shortfall while lawmakers determine how to bring the state's spending back into line. But there are limits to how much the state can lean on those investments to cover its budget shortfall, said state Treasurer Dean Martin.

Martin's office oversees the investment pool, which he described as a sort of large mutual fund. All revenue the state collects is pooled and invested, and the state divests when it has bills to pay.

"It's exactly the same way that a mutual fund works. When you buy a mutual fund, you're not buying every one of those investments that they have. You're buying a share in a pool, and the pool buys the investments," Martin said. "You get the benefit of those big long-term investments, even though you're coming in and out constantly with short-term dollars.

"The large pool can manage that because everybody else is putting money in and (taking it) out, and if you've got a large enough pool of people at the same time, you've generally got somebody making deposits at the same time somebody else is making withdrawals."

Everybody is still making investments, but lately the state is taking out far more, meaning that the state's share of the pool has been diminished. In May 2007, the pool was worth $12.37 billion, with the state's share at about $5.7 billion, according to Martin's office. By September 2008, the state's share had shrunk to $4.26 billion.

Devalued investments are common these days, but the state's problem isn't that its investments are becoming less valuable, Martin said. Most of the money is in U.S. Treasury bills or other government-sponsored entities, Martin said.

Dennis Hoffman, a professor at Arizona State University's W.P. Carey School of Business, said U.S. treasuries are essentially an I.O.U. from the federal government, and are considered to be among the safest possible investments.

"It is indeed a case that you're going to get the principle, plus interest, back, even though interest is miniscule at this point," Hoffman said.

State Sen. Robert Blendu, a financial adviser with the investment bank Morgan Stanley, said investing in U.S. treasuries is a sound policy for the state because, "the only way that I lose out is for the federal government to go broke."

"If you had been involved in the stock market, you've got to be down by 50 percent," Blendu said. "Our treasurer is still getting 5.5 percent-plus on some of those treasuries. While people are waiting for the stock market to come back, he's busy collecting checks and getting paid for all that."

The battered economy hasn't much affected the value of the state's investments, but the economic slump still has shrunk the state's share of the pool. As the economy worsened and state tax revenues sharply decreased, the state continued to draw down on the operating account, which is the portion of its investments that is available to the general fund.

"The best way to describe that is that's the general fund's checkbook," Martin said.

In January 2007, the operating account had about $2.4 billion, Martin said, but a year later it was down to $1.8 billion. The balance now is about $564 million, and Martin worries that it may be spent down to zero if the fiscal year 2009 budget is not amended quickly.

"That is definitely going to happen in … the calendar year 2009," Martin said. "There's no way around it unless they change the way they're doing their budget. It could potentially happen as early as December."

The portion of the state's investments separate from the operating account is distributed among hundreds of funds that serve specific agencies or programs, Martin said. The state's investments are spread over 1,800 accounts, about 1,300 of which are earmarked for non-general fund purposes, he said. For example, gas-tax revenues are required by law to be segregated so they can be used for transportation projects, while other accounts can be used only for specific bond payments.

The state's percentage share in the investment pool has dropped as well, along with the investments' total value. In May 2007, the state's investments made up 46 percent of the pool, while the Local Government Investment Pool, the portion shared by dozens of cities and towns, equaled 34 percent and the land trust endowment had 20 percent. As of September of this year, the state's share had shrunk to 36 percent while the Local Government Investment Pool was up to 43 percent, which Martin said is the first time in the state's history that local governments have held a larger share of the pool than the state.

The reason for that, Martin said, is that while the state has spent down its share of the pool, local governments have been increasing their investments. The cities and towns are facing the same fiscal problems as the state, but unlike the state they are not required by law to put all of their revenue into the pool. As the recession has worn on, local governments have been putting a larger share of their revenues into the pool because its investments are safer than most of their other options, Martin said.

The safety of those investments, specifically the U.S. treasuries and government-backed bonds, might be attractive to local government entities, but it puts limits on how much profit the fund can make. Investments in U.S. treasuries almost always bear fruit, but the yield is low and getting lower. In November alone, the interest rates on 30-day treasury bills dropped from .20 percent to .09 percent in less than three weeks.

The Federal Reserve cuts interest rates when the economy is down, which, Martin said, makes the treasury bills less valuable, though still reliable, investments.

“My philosophy is safety first, then liquidity, then yield. Yield’s the last thing we look at. It has to meet our safety and liquidity needs before we even look at yield,” Martin said.

Even if the state amends the budget to balance spending with revenue, halting the drawdown of its cash reserves in the process, the investment pool will continue to feel the effects, Martin said. As the investments mature and are cashed out, they are continually reinvested to increase the pool’s total value. With significantly less cash to work with, Martin said the investments will be far less profitable.

Take, for example, the account known as the rainy day fund, which was nearly cleared out last fiscal year and is expected to be completely drained after lawmakers fix this year’s budget. A year ago, Martin said, the rainy day fund held about $500 million dollars, and the pool in which it had been invested was getting an average rate of return of about 4 percent. But with the fund nearly empty, that money can’t be put into new investments, and the state loses out on the profits, which could continue to cost the state even after the economy recovers and tax revenues start to rise.

“What’s 4 percent interest on half-a-billion?” Martin said. “It cost the state $20 million in interest income, roughly.”

The pressure that the budget crisis is putting on the investment pool also forces the state to rely on shorter-term investments, which bring diminished returns. While a one-month treasury bill has a .09 percent yield, a one-year bill has a .97 percent return and a 10-year bill has 3.38 percent return.

A special session of the Legislature is needed to amend the budget, and Gov. Janet Napolitano is in negotiations with state House and Senate leaders to find a solution that will survive both a legislative vote and the governor’s veto pen. A lot depends on how much the two sides can agree, and whether Napolitano, who is reported to be President-elect Barack Obama’s choice to head up the Department of Homeland Security, will be around when the special session begins.

It’s normal for the state to draw down its cash reserves when the economy is slumping, but Martin said Arizona’s problems were compounded by the state’s failure to reduce spending over the past two fiscal years. The fund will not stop shrinking until spending is brought in line with the state’s decreased revenue projections, he said.

Senate Appropriations Chairman Bob Burns said the budget crisis needs a speedy resolution so the investment pool can stop shrinking and start making money again.

“If the investment is not producing, obviously we’re not making money and that’s a loss to the general fund,” said Burns, the incoming Senate president.

The biggest concern surrounding the operating account is what to do if the balance drops to zero. The state already has postponed $600 million in payments for K-12 education into the beginning of the 2010 fiscal year, which begins in July. That rollover, as the accounting method is known, will leave the state with an extraordinarily large bill at the beginning of a fiscal year that is expected to see tax revenues drop even further than in 2009.

Though the state Constitution essentially forbids Arizona from borrowing money, Martin said there are loopholes, such as rollovers, that the state might have to use if the operating account drops to, or nears, zero. New facilities can be paid for under lease-purchase agreements, in which the state essentially rents to own buildings, and bonding is always an option for major projects. The state can sell some of its buildings and lease them back from the buyers.

The state also can securitize future revenue streams, meaning future revenues are traded for lump sums of cash today, which Napolitano has proposed doing with the state Lottery.

Arizona is far from alone in its budget crunch. Most other states are facing similar shortfalls, though Martin said Arizona has the largest per-capita deficit in the country. If so, Arizona can take solace in the fact that some other states' investment pools aren't nearly as secure as its own.

In Florida, local governments pulled

$8 billion, a 30 percent share, from the state's investment pool a year ago after learning that the fund included more than $700 million in debt that had gone into default, leading the state to temporarily freeze withdrawals. Local governments and school districts also pulled $247 million out of Montana's investment pool due to concern about investments in risky subprime loans.

By Jeremy Duda
Arizona Capitol Times